FOR ARGUMENT

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-561

UNITED STATES OF AMERICA,
Petitioner,

vs.

NEIL T. NAFTALIN,
Respondent.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether Section 17(a)(1) of the Securities Act of 1933 is sufficiently broad in scope, as a criminal statute, to encompass a misrepresentation by a customer to a stockbroker in employing its services as agent to effect an undisclosed short sale of securities through the facilities of the New York Stock Exchange, where no offer or sale is made to the broker, and no purchaser of securities is either deceived or damaged.

STATUTE INVOLVED

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

STATEMENT OF THE CASE

The Government's Statement reflects a basic lack of understanding of securities transactions effected through the facilities of the New York Stock Exchange ("NYSE" or "Exchange"), as well as undisputed facts central to the eight short-sale transactions which form the subject matter of the indictment. Because the resulting confusion pervades the Government's argument concerning the nature of the transactions and their alleged impact on investors, a fundamental illustration of both Exchange transactions and the transactions in question is required.

The Typical Exchange Transaction

The transactions in question occurred in July and August 1969. At that time, as at present, the typical transaction in securities listed on the Exchange involved a four-link chain: the selling customer ("Seller"); his broker; the purchasing customer's broker; and the purchasing customer ("Purchaser").

To illustrate: When a Seller, let's say in Minneapolis, decides to sell a listed security, say 100 shares of IBM, he calls his stockbroker, acting as his agent, and instructs the broker to sell the 100 shares, typically at the prevailing market price. His broker, say the Minneapolis office of Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch"), transmits the sell order to the floor of the Exchange in New York, where it is delivered to the specialist in IBM stock.

Perhaps simultaneously, somewhere else in the country, a Purchaser decides to buy 100 shares of IBM. The Purchaser, say in Baltimore, calls his broker, acting as his agent, and instructs him to buy 100 shares of IBM at the prevailing market price. The Purchaser's broker, say the Baltimore office of Paine Webber, Jackson & Curtis ("Paine Webber"), transmits the buy order to the floor of the Exchange, where it is delivered to the specialist in IBM stock.

The specialist now has in hand both sell and buy orders for 100 shares of IBM "at the market". He matches up the order tickets, at the prevailing price, say $100 per share, thereby effecting a transaction between Seller and Purchaser.

The respective brokers are immediately advised of the

trade and price, and are identified to each other. Merrill Lynch learns that its customer, the Seller, has sold 100 shares of IBM at $100 per share, or $10,000 [less Merrill Lynch's agency commission], to an unidentified purchaser represented by Paine Webber. Paine Webber learns that its customer, the Purchaser, has purchased 100 shares of IBM for $10,000 [plus Paine Webber's agency commission] from an unidentified seller represented by Merrill Lynch.

The day on which the foregoing transpires is the trade date ("Trade Date"). By industry rule and practice, the transaction is closed five business days, or seven calendar days, later, on the settlement date ("Settlement Date").[1]

On the Settlement Date, either physically, by bookkeeping entry or in a clearinghouse transaction, Merrill Lynch [Minneapolis] delivers 100 shares of IBM to Paine Webber [Baltimore] and receives $10,000 from it.

In the meantime, between Trade Date and Settlement Date, Merrill Lynch and Paine Webber send written confirmations of the transaction to their respective customers. Merrill Lynch's confirmation statement to the Seller, *i.e.*, its contract with its customer, advises the Seller that he sold 100 shares of IBM at $100 per share on the Trade Date, with Merrill Lynch acting as his agent, and instructs him that his certificate for 100 shares of IBM must be delivered to Merrill Lynch [if Merrill Lynch does not already have it] by the Settlement Date. Upon delivery of the certificate, and only upon delivery, the Seller receives payment of $10,000 [less Merrill Lynch's commission].

[1]Until 1946, the industry imposed a two-business-day settlement requirement on all contracts. The settlement date was thereafter successively changed to three business days in August 1946; to four business days in March 1952; and to five business days in February 1968, all to provide additional time for the settlement process. See NYSE Rule 64.

Paine Webber's confirmation statement to the Purchaser, *i.e.*, its contract with its customer, advises the Purchaser that he bought 100 shares of IBM at $100 per share on the Trade Date, and instructs him that he must pay $10,000 [plus Paine Webber's commission] for the stock no later than the Settlement Date.

What happens if the Seller does not deliver a certificate for 100 shares of IBM to Merrill Lynch on the Settlement Date? *Merrill Lynch "borrows" 100 shares of IBM, either from its own inventory, from the "inventory" of its margin-account customers, or from another broker,[2] and "loans" it to the Seller, for his account, in order to complete the transaction.* In essence, Merrill Lynch thereby extends credit to the Seller equal to the value of the stock loaned for his account.[3]

Thus, on Settlement Date, Merrill Lynch delivers 100 borrowed shares of IBM to Paine Webber, and receives $10,000 in exchange. Merrill Lynch does not deliver the $10,000 to the Seller, however. It holds the funds for payment against delivery of a certificate for 100 shares of IBM.

One more point on Merrill Lynch's rights vis-á-vis the Seller on Settlement Date. If the Seller does not deliver a certificate for 100 shares on the Settlement Date, it is in breach of contract, and Merrill Lynch has the right to purchase the stock in the market for the Seller's account, and to recover damages for the difference, if any, between the price at which the Seller sold [$100 per share] and the

[2]In exchange, the lending broker obtains the use of funds equal to the value of the stock borrowed.

[3]Section 7 of the Securities Exchange Act of 1934, 15 U.S.C. § 78g, governs the extension of credit by brokers to their customers in securities transactions. Section 7(c) of the Act spawned Regulation T, 12 C.F.R. § 220, a comprehensive statement by the Federal Reserve Board of the circumstances under which credit may be extended.

price which Merrill Lynch pays to replace the undelivered shares, say $105 per share. The latter replacement transaction is a customer "buy-in", *i.e.*, a purchase for the Seller's account.[4]

It is plain that the Government understands neither the general function of such a buy-in, nor the facts concerning the buy-ins effected in connection with the transactions covered in the indictment. [*E.g.*, G.Br. 5, 12, 23-25.]

The Transactions in Question

With one exception,[5] the sale transactions covered in the indictment were entered on the NYSE on their Trade Dates, and closed on their Settlement Dates, in the manner just described.

The Respondent was the principal of Naftalin & Co., Inc. ("Naftalin"), which was registered as a broker-dealer under the securities laws, but which had ceased doing business with the public in 1963. In 1969, Naftalin was trading for its own account, at the Respondent's direction, through brokers who were either members of the NYSE, or enjoyed correspondent relationships with Exchange members. The brokers through whom the transactions were effected knew that Naftalin did not have a public business; knew the Respondent as a sophisticated investor running

[4]Customer buy-ins are required by regulation under certain circumstances, but they do not serve as a vehicle for concluding the delivery of stock to the Purchaser or his broker on Settlement Date. See SEC Rule 10a-2, 17 C.F.R. § 240.10a-2. In addition, the SEC has recently imposed a mandatory 10-business-day post-Settlement Date customer buy-in requirement on all Exchange transactions, if the broker has not obtained possession of the stock from its customer "for any reason whatsoever". SEC Rule 15c3-(3)(m), 17 C.F.R. § 240.15c3-3(m).

[5]See n. 13, *infra*.

a one-man operation; and, in each instance, knew him through a prior course of dealing as a regular customer, albeit a large and theretofore profitable one. [Pet.App. 3a; *e.g.*, Tr. 37-9, 48-9, R.Ex. A, Tr. 177-9, R.Exs. G-H, Tr. 158, 302, R.Ex. K, Tr. 193, 331-3.]

The Respondent was engaged in a "short selling" scheme, essentially as described by the lower courts [Pet. App. 2a-5a, 16a-20a], and we intend no further debate here on the sufficiency of the evidence to support the finding of what the court of appeals described as a "species of fraud practiced against the defrauded brokers, who were not purchasers. . . ." [Pet. App. 5a.]

In seven separate instances in July and August 1969, the Respondent instructed five brokers[6] with whom Naftalin maintained cash accounts to sell stocks listed on the Exchange for the account of Naftalin, which Naftalin did not own when the instructions were given.[7] He did so in a manner which would be understood by the brokers who took the orders as a representation that Naftalin owned the stocks it was selling.[8] Likewise, the Respondent en-

[6]Merrill Lynch; Paine Webber; Piper, Jaffray & Hopwood, Inc.; Dain, Kalman & Quail, Inc.; and H. S. Kipnis & Co.

[7]Under Regulation T, 12 C.F.R. § 220.4(c)(1)(ii), a broker may effect "bona fide cash transactions" for a customer in a Special Cash Account, in which the broker may "sell any security for . . . any customer, provided the security is held in the account or the [broker] is informed that the customer or his principal owns the security and the . . . sale is in reliance upon an agreement accepted by the [broker] in good faith that the security is to be promptly deposited in the account."

[8]Under Regulation T, 12 C.F.R. § 220.3, a broker may effect a sale of stock which the customer does not own, *i.e.*, a "short sale", only in a General Account, commonly referred to as a "margin account", if the broker obtains a deposit of cash or securities having a collateral value equal to a specified percentage of the sale price. The deposit of cash or securities is received as collateral for a "loan" of the securities sold short, to complete the transaction on Settlement Date, subject to later purchase and delivery of the securities by the customer to repay the "loan" from the broker.

tered the sell orders in the expectation that (a) the market price of the stock sold would decline, (b) the brokers would not require delivery of the stock certificates for a considerable period of time, (c) the same stocks could be purchased from other brokers thereafter at a lower price, and certificates obtained promptly, and (d) the stocks could be delivered to the selling brokers in exchange for the original sales proceeds, with a resulting profit.

Each of the transactions occurred in essentially the same fashion as the following example, which describes the short sale charged in Count II of the indictment.

On August 5, 1969, the Respondent called the registered representative assigned to Naftalin's account in Paine Webber's Minneapolis office and said "Sell long 1,000 Burroughs at the market for Naftalin & Company". [Tr. 25.] The representative wrote up an order ticket, the order was transmitted to the floor of the Exchange in New York and a sale was promptly confirmed.[9] [Tr. 25-7, 45-6.] Of the 1,000 shares sold, 900 shares were sold at $135.50 per share and 100 were sold at $135.25 per share.[10] [Tr. 26, G.Ex. 6.]

Following the Trade Date, Paine Webber sent confirmations of the transaction to Naftalin, confirming the sale and prices, and indicating that delivery of 1,000 shares of Burroughs was due on August 12, the Settlement Date, against payment of the net sale proceeds ($134,699, af-

[9]The record does not reflect the identity of the broker on the other side of this, or any other, transaction charged in the indictment, nor the identity of the Purchasers for whom such brokers acted.

[10]Stocks listed on the Exchange are sold in "round lots" of 100 shares. A sale of 1,000 shares "at the market" may thus involve sales of one or more round lots at one or more prices. In that event, the Seller's broker prepares separate confirmation statements for shares sold at different prices.

ter payment of commissions of $525 to Paine Webber and applicable taxes.). [Tr. 29-30; G.Exs. 2, 3.]

On the Settlement Date, Paine Webber had not received a certificate for 1,000 Burroughs from Naftalin. As was its custom, it did not call the Respondent to inquire about the certificate. Instead, Paine Webber borrowed 1,000 shares of Burroughs from another broker; delivered the borrowed shares to the broker on the other side of the transaction, for Naftalin's account; and received the sale proceeds of $135,225. [Tr. 86, 90-3.] It did not deliver the sale proceeds to Naftalin; it held them to await delivery of the stock, which never arrived. [Tr. 47-8; 90.]

In summary, as of the Settlement Date, the transaction effected on the Exchange, as between the broker for the Seller and the broker for the Purchaser, was completed. The stock sold, 1,000 Burroughs, was in the custody of the Purchaser's broker; the sale proceeds were in the possession of Paine Webber, to be paid to Naftalin against delivery of stock, 1,000 Burroughs, to replace the stock borrowed for Naftalin's account.

Thereafter, toward the end of August, and again in late September or early October 1969, a representative of Paine Webber called the Respondent to inquire about the 1,000 shares of Burroughs, and another transaction.[11] and was advised that the Respondent "was having difficulties obtaining the securities from a third party and would deliver them when he was able to." [Tr. 83-4.]

Ultimately, the Respondent's short-selling scheme collapsed, by reason of a precipitous rise in the market price of the stocks sold short, and Naftalin's resulting financial

[11]The July 22, 1969 sale of 500 shares of American Research and Development charged in Count I of the indictment.

inability to make covering purchases through other brokers.

On October 27, 1969, the Respondent called a meeting of the brokers involved and advised them of what had happened.[12] On the same day, Paine Webber executed a customer buy-in of 1,000 Burroughs for Naftalin's account, at $161 per share, for a total of $161,551 (including Paine Webber's agency commission of $551 on the purchase). [Tr. 87, 109-10; G.Ex. 7.] On the Settlement Date of that transaction, November 3, Paine Webber charged Naftalin's account with the difference between the buy-in price and the original sale proceeds, *i.e.*, approximately $26,800, representing Paine Webber's loss on the buy-in. [Tr. 87-8, 95.]

The stock received by Paine Webber on its customer buy-in was, and could only have been, used to replace the stock "borrowed" from another broker on August 12, and loaned to Naftalin's account, to conclude the earlier transaction. It was not used, as the Government says, to fulfill Paine Webber's "commitment to purchasers". [G.Br. 5.]

Each of the other short sale transactions charged in the indictment, except one,[13] bears the essential character-

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[12]The Government misstates the date of the meeting as being in September 1969. [G.Br. 5.]

[13]Count VI of the indictment involves an undisclosed short sale of 1,000 shares of Fairchild Camera by Naftalin, as principal, to H. S. Kipnis & Co. ("Kipnis"), as principal, on August 28, 1969, which was not executed through the facilities of the Exchange. [Tr. 143, G.Ex. 12, Def. Ex. C, Tr. 163.] Over-the-counter transactions in securities listed on the Exchange are known as "third market" trades. [Tr. 135.] Kipnis, which was not a member of the NYSE, was a third market maker in listed stocks, and traded with Naftalin from time to time as such. [Tr. 144.] On agency transactions for Naftalin, Kipnis employed the services of a correspondent broker in New York which was an Exchange member. [Tr. 139, 182.] Although the court of appeals struggled with

istics of the transaction just described. The Respondent gave sell orders to the brokers, as Naftalin's agents, on the respective Trade Dates, misrepresenting by statement or implication Naftalin's ownership of the securities sold;[14] the orders were executed on the Exchange;[15] the brokers sent confirmation statements to Naftalin, as their customer;[16] the brokers concluded the transactions with the brokers for the respective purchasers on the respective Settlement Dates by borrowing the stocks from other sources and loaning them to Naftalin's account;[17] the brokers received the proceeds of each sale, but did not deliver them to Naftalin, holding them instead against delivery of stock

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Count VI, ultimately dismissing it for its failure to allege that Kipnis was a "purchaser" of the stock, in our view an additional basis for dismissal is that Kipnis was in no way deceived by the short sale. Short selling in the third market was not regulated in 1969, and was a common occurrence among sophisticated traders, trading as principals, without disclosure. [Tr. 158-60, 164, 362-3.] In such trading, the purchaser is not concerned with whether the seller is "long" or "short" at the time of sale, but only that the seller has the wherewithal to obtain and deliver the stock, which Naftalin then had. In that regard, the Respondent made a "mark to market" payment of $93,000 to Kipnis on September 4, 1969, to cover the difference between the sale prices of Naftalin's open transactions with Kipnis and the market increases which had occurred on those stocks to that date. [Tr. 146-7, 153-4, R.Ex. B.] In any event, the Government has not raised the dismissal of Count VI for review. [G.Br. 7, n. 8.]

[14]Tr. 19, 55-8, 67-9 [Count I]; Tr. 237-9, 242-4 [Count III]; Tr. 313-4, 330-3 [Count IV]; Tr. 120-3, 127-30 [Count V]; Tr. 152-3, 357-60, 364-66, 371-2 [Counts VII and VIII].

[15]Tr. 21, G.Ex. 5, Tr. 45-6 [Count I]; Tr. 239-41, G.Ex. 19, Tr. 249-50, 278-9 [Count III]; Tr. 314-7, G.Ex. 25, Tr. 325 [Count IV]; Tr. 121, G.Ex. 9, Tr. 122, 125, 130 [Count V]; Tr. 138-9, 150, 358-60, G.Exs. 29-30, Tr. 365-9 [Counts VII and VIII].

[16]Tr. 30, G.Ex. 4 [Count I]; Tr. 258, G.Ex. 20 [Count III]; Tr. 318, G.Exs. 26-27 [Count IV]; Tr. 123-4, G.Exs. 10-11 [Count V]; Tr. 142-4, G.Exs. 13-14 [Counts VII and VIII].

[17]Tr. 46-7, 85-6, 90-3 [Count I]; Tr. 250-2, 267, 300-1 [Count III]; Tr. 322-5, 335-41 [Count IV]; Tr. 217-8 [Count V]; Tr. 182-6 [Counts VII and VIII].

certificates which never arrived;[18] the Respondent made post-sale misrepresentations concerning delivery;[19] and the brokers executed customer buy-ins in late October 1969, for Naftalin's account, in order to return the borrowed stocks, charging the purchase prices to Naftalin's account, and sustaining losses thereby.[20]

Subsequent Procedural History

Two days after the Respondent's disclosure of his short-selling activities to the brokers on October 27, 1969, he made a detailed disclosure of the entire scheme to the Securities Exchange Commission ("SEC") at a meeting with SEC officials in Washington, D.C. The eight transactions ultimately charged in the indictment immediately became the subject matter of litigation, at the Government's instance, or with its active participation, as follows:

1. On November 4, 1969, the SEC commenced a civil action against Naftalin and the Respondent, and obtained a preliminary injunction, with their consent, restraining them from violations of Section 10(b) of the 1934 Act, and Section 17(a) of the 1933 Act, predicated on the short-selling activities. Following the appointment of a receiver for Naftalin in December 1969, the injunctive action remained essentially dormant until its conclusion by the entry of a permanent injunction, also by consent, on August 29, 1972.[21]

2. On February 10 and 18, 1970, separate involuntary petitions in bankruptcy were filed against Naftalin by six brokers through whom Naftalin had made undisclosed short sales, including Merrill Lynch, Paine Webber, Piper Jaffray and Kipnis, in which the brokers asserted claims based upon losses sustained in executing their customer buy-ins.[22] The SEC [Chicago] assisted counsel for the brokers in the preparation of the petitions, and monitored the proceedings closely for more than two years. Then, in March 1972, the SEC [Washington] participated as *amicus curiae* in an appeal by the brokers from the district court's order limiting their contract damage claims.[23] It urged the appellate court to either severely limit or invalidate the brokers' claims on the grounds that the brokers had unlawfully extended credit to Naftalin in violation of Section 7 (c) of the 1934 Act, and Regulation T, by executing sell orders in cash accounts knowing that prior sale transactions had not settled promptly, and by failing to execute customer buy-ins shortly after the settlement dates of the transactions.[24]

3. In the meantime, on September 30, 1971, the SEC [Chicago] commenced an administrative proceeding against Naftalin and the Respondent under Section 15 of

[18]Tr. 47, 90 [Count I]; Tr. 251, 267, 301 [Count III]; Tr. 319-20 [Count IV]; Tr. 221 [Count V]; Tr. 162 [Counts VII and VIII].
[19]Tr. 34 [Count I]; Tr. 255-6, 259-63, 272 [Count III]; Tr. 344 [Count IV]; Tr. 189-90 [Count V]; Tr. 146 [Counts VII and VIII].
[20]Tr. 87-9, 108-10, G.Ex. 8 [Count I]; Tr. 281-2, G.Exs. 21-22, Tr. 306 [Count III]; Tr. 320-1, G.Ex. 28, Tr. 345-50 [Count IV] [Dain, Kalman realized a profit of $3,000 on the buy-in of the short sale charged in Count IV, which it offset against a loss of $20,000 on the buy-in of a short sale not covered in the indictment]; Tr. 204-6, G.Ex. 15, Tr. 218, 225, 227-9, G.Exs. 16-17 [Count V]; Tr. 167-74, R.Exs. D-F [Counts VII and VIII].

[21]*SEC v. Naftalin & Co., Inc., et al.*, 4-69 Civ. 385 (D. Minn. 1969).
[22]*In re Naftalin & Co., Inc.*, 4-70 Bky. 137, 170 (D. Minn. 1970); 315 F.Supp. 463 (D. Minn. 1970); 333 F.Supp. 136 (D. Minn. 1971).
[23]*Naftalin & Co., Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166 (8th Cir. 1972).
[24]*Id.*, SEC Br., *amicus curiae*, at 12-22 (March 29, 1972).

the 1934 Act, seeking to revoke Naftalin's broker-dealer registration, and to bar the Respondent from the securities industry for life, for violations of Section 10(b) of the 1934 Act and Section 17(a) of the 1933 Act.[25] At the hearing in November 1972, the SEC sought to establish the violations on the basis of the eight short-sale transactions ultimately alleged in the indictment, through the same witnesses who ultimately testified at the criminal trial. On June 19, 1973, the administrative proceeding concluded with a final decision revoking Naftalin's registration and barring the Respondent "from association with any broker or dealer". [R.Exs. Z-7, Z-8.]

The present indictment was returned against the Respondent on April 11, 1974, charging violations of Section 17(a) of the 1933 Act, but omitting reference to Section 10(b) of the 1934 Act.[26] To the best of our knowledge, the indictment represented the first prosecution of short-selling activities under Section 17(a) in the 41-year history of the statute.

On August 8, 1975, the district court dismissed the indictment on the ground that the Government's four and one-half year delay in presenting the matter to the grand jury presented an "outrageous case" of pre-indictment delay, denying the Respondent due process of law. On appeal by the Government, the indictment was reinstated by the

[25] *In re Naftalin & Co., Inc. and Neil T. Naftalin,* SEC File No. 3-3277 (September 30, 1971).

[26] The basis for the Government's decision to prosecute under Section 17(a) must be left to conjecture. The maximum penalty for violations of Section 17(a) was and is a five-year prison term. 15 U.S.C. § 77x. The maximum penalty for violations of Section 10(b) of the 1934 Act was, until June 4, 1975, a two-year prison term, when an amendment increasing the maximum to a five-year term became effective. 15 U.S.C. § 78ff.

Eighth Circuit. This Court denied the Respondent's petition for a writ of certiorari.[27]

The district court subsequently denied a motion by the Respondent to dismiss the indictment on the ground that the permanent bar from the securities industry imposed upon him by the SEC in the administrative proceeding as a penalty for the same short sale transactions, placed him in double jeopardy. The indictment was thereafter tried to the court in December 1976, the Respondent having waived a jury trial. On February 1, 1977, the Respondent was convicted on all eight counts. On March 18, 1977, the district court denied the Respondent's renewed motion for dismissal on the ground of double jeopardy, and sentenced the Respondent to concurrent five-year prison terms on each count.[28]

On June 13, 1978, the Eighth Circuit reversed the conviction and dismissed the indictment on the ground that Section 17(a) of the 1933 Act does not reach the "species of fraud" in question.[29] It noted that "as between [Respondent] and the brokers, there was no offer or sale of securities", and that the "purchasers to whom the brokers sold were not deceived or defrauded in any way." [Pet. App. 6a] It held that the purpose of Section 17(a) of the 1933 Act "was to protect investors from fraudulent practices in the sale of securities" and that "the government

[27] *United States v. Naftalin,* 534 F.2d 770 (8th Cir. 1976), *cert. denied,* 429 U.S. 827 (1977).

[28] The Respondent surrendered to the U.S. Marshal on the same day, and was incarcerated in the federal prison at Sandstone, Minnesota. He was released on August 12, 1977, on $500 bond, pending appeal. [G.App. 10.]

[29] *United States v. Naftalin,* 579 F.2d 444 (8th Cir. 1978); Pet. App. 1a-11a. As a result, the court did not reach the Respondent's double jeopardy claim.

must prove some impact of the scheme on an investor." [Pet.App. 6a-7a, 8a.]

This Court granted certiorari on December 11, 1978.

SUMMARY OF ARGUMENT

Section 17(a)(1) of the Securities Act of 1933 prohibits only fraud "in the offer or sale" of a security. The statute is inapplicable by its terms to the Respondent's deception of his brokers in engaging their services to effect sales transactions for Naftalin's account on the New York Stock Exchange, in that no offer or sale of stock to the brokers was involved.

Properly construed, each of subparagraphs (1), (2) and (3) of Section 17(a) requires the employment of a fraudulent or deceptive practice upon an offeree or purchaser of securities. The statute is inapplicable by its terms to the Respondent's deception of his brokers, who were neither.

Section 17(a) of the 1933 Act was intended by Congress to protect investors, principally in connection with the initial issuance of securities in public offerings, as the first step toward the ultimate objective of comprehensive federal regulation of securities transactions. Congress understood that the legislation did not address the full spectrum of abuses in securities trading, including those relating to extensions of credit and excessive short-selling. It left the regulation of the latter abuses to the Securities Exchange Act of 1934.

The 1934 Act, particularly in Sections 7 and 10, contains provisions which directly bear upon the Respondent's short-selling activities, and are designed to protect brokers from the fraudulent practices of their customers.

The Government elected to prosecute the Respondent under an inappropriate criminal statute, with full awareness of the appropriate statutory and regulatory weapons in its arsenal. The dismissal of the indictment should therefore be affirmed.

ARGUMENT

MISREPRESENTATIONS BY A CUSTOMER TO ITS BROKER IN CAUSING THE BROKER TO EFFECT THE SHORT SALE OF A SECURITY ON THE EXCHANGE DO NOT VIOLATE SECTION 17(a) OF THE SECURITIES ACT OF 1933, WHERE NO OFFER OR SALE IS MADE TO THE BROKER, AND NO PURCHASER OF SECURITIES IS EITHER DECEIVED OR DAMAGED.

The court of appeals correctly recognized that the Respondent's course of conduct with the brokers is not the "species" of misconduct proscribed, or intended to be proscribed, by Section 17(a), The analysis of Exchange transactions and the transactions involved in the indictment in the preceding pages suggests the reasons.

1. Misrepresentations by a customer to its broker do not constitute fraud "in the offer or sale" of a security.

The statute prohibits fraud "in the offer or sale" of securities. The word "in" is "a function word to indicate inclusion, location or position within limits." Webster's New Collegiate Dictionary (1977). It denotes conduct within the confines of an offer to sell, or a sale itself, and thereby proscribes only conduct directed at the recipient of an offer or the purchaser of securities. The word "in" is to be con-

trasted with the phrase "in connection with", found in Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), which connotes a far broader range of activities surrounding a sale transaction.

The definitions of the terms "offer" and "sale" in Section 2(3) of the 1933 Act, 15 U.S.C. § 77b(3), lend no greater expanse to the word "in". The definition of "offer" as an "attempt . . . to dispose of . . . a security for value" does not alter the statutory requirement that the fraud occur "in" the attempted disposition, *i.e.*, in conduct directed to a prospective investor. Likewise, the definition of "sale" as a "contract of sale or disposition of security . . . for value" does not alter the requirement that the fraud occur "in" the disposition for value, i.e., in conduct directed at the investor.[30]

"In order to sustain a conviction the Government must show some impact of the scheme on the investor. . . ." *United States v. Schaefer*, 299 F.2d 625, 629 (7th Cir.), *cert. denied*, 370 U.S. 917 (1962). "[W]hat must be shown is that the scheme had an impact on the investor. . . ." *United States v. Ashdown*, 509 F.2d 793, 799 (5th Cir.), *cert. denied*, 423 U.S. 829 (1975).

As the court of appeals observed, the scheme employed by the Respondent, directed at the brokers, involved no offers to sell or sales to them.[31] The Respondent employed the brokers as his agents to sell securities listed on

[30]The definition of "sale" also includes the disposition of an "interest in a security", which accounts for *United States v. Gentile*, 530 F.2d 461 (2d Cir.), *cert. denied*, 462 U.S. 936 (1976), cited by the Government. [G.Br. 22.]

[31]The district court found only fraud in the "sale" of securities. [Pet.App. 20a] The court of appeals found fraud in neither "offer" nor "sale". [Pet.App. 6a] "Offer" and "sale", of course, are distinct acts. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 733 n. 5 (1975).

the Exchange, and he did so by misleading statements and omissions. The sales were made and closed with the purchasers without incident, however, and no purchaser was deceived or injured in any way. Therefore, no fraud occurred "in the offer or sale" of the securities, within the language of the statute.

2. Misrepresentations by a customer to its broker do not constitute fraud upon an offeree or purchaser.

The limitation imposed by the word "in", as the introductory word in the phrase "in the offer or sale of any securities", is supported by reviewing Section 17(a) as a whole. The statute provides:

> It shall be unlawful for any person in the offer or sale of any securities . . . directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon *the purchaser*. (Emphasis added.]

As is implicit from the introductory phrase "in the offer or sale", the words "the purchaser" in subparagraph (3) should be read into subparagraphs (1) and (2), to reflect the clear intention of the drafters of the legislation. Thus, the statute should be construed to read as follows:

> It shall be unlawful for any person *in the offer or sale* of any securities . . . directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud [*an offeree or purchaser*], or
>
> (2) to obtain money or property [*from an offeree or purchaser*] by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon [*an offeree or*] *the purchaser*. [Emphasis and bracketed material added.]

If the numbered subparagraphs of the statute had not been numbered, or if the words "the purchaser" had been separated from subparagraph (3) and set off at the left margin, with minor grammatical corrections, as they should have been, the intended meaning of the statute would have been manifest.[32]

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[32]See, for example, Section 12 of the 1933 Act, 15 U.S.C. § 77*l*, which provides:

Any person who—

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security. [Emphasis added.]

The italicized phrase clearly modifies both subparagraphs (1) and (2). See also SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, p. 31, *infra*.

As the Government notes [G.Br. 17], the original form of the statute in the legislative process read as follows:

> [I]t shall be unlawful for any person, firm, corporation, or other entity in any interstate sale, promotion, negotiation, advertisement, or distribution of any securities defined by this Act willfully to employ any device, scheme, or artifice to defraud or to obtain money or property by means of any false pretense, representation or promise, or to engage in any transaction, practice, or course of business relating to the interstate purchase or sale of any securities which operates or would operate as a fraud upon the purchaser.[33]

Again, the use of the phrase "in any . . . sale" was plainly meant to proscribe conduct directed toward, and impacting, purchasers, and the words "the purchaser" were intended to modify the preceding clauses relating to schemes to defraud and obtaining money by false pretenses. The restructuring of Section 17(a) by separating its constituent clauses and numbering them should not be permitted to alter the intended meaning of the statute as a whole, particularly as a criminal statute, simply because the restructurers were inexact in their assigned task.

"[P]unctuation is not decisive of the construction of a statute." *Costanzo v. Tillinghast*, 287 U.S. 341, 344 (1932). In *Porto Rico Railway, Light and Power Co. v. Diez*, 253 U.S. 345, 348 (1919), this Court said:

> When several words are followed by a clause which is applicable as much to the first and other words as to the last, the natural construction of the language demands that the clause be read as applicable to all.

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[33]Section 13 of S.875, 73d Cong., 1st Sess. (1933) and H.R. 4314, 73d Cong., 1st Sess. (1933).

See also United States v. Bass, 404 U.S. 336, 339 n. 6 (1971).

In view of the legislative history of the statute, discussed below, "it is reasonable to conclude that Congress intended to bring the [purchaser] limitation to apply to . . ." Section 17(a)(1). *Federal Maritime Commission v. Seatrain Lines, Inc.,* 411 U.S. 726, 734 (1973).

The court of appeals and other lower courts which have viewed the statute critically are therefore clearly correct in holding that the Government must prove "some impact of the scheme on an investor" for a conviction under Section 17(a)(1). *United States v. Ashdown,* 509 F.2d 793, 799 (5th Cir.), *cert. denied,* 423 U.S. 829 (1975); *United States v. Schaefer,* 299 F.2d 625, 629-30 (7th Cir.), *cert. denied,* 370 U.S. 917 (1962).[34] As the court of appeals likewise held, the present record contains no evidence that any investor was injured or deceived in any way by the Respondent's misrepresentations to the brokers.

3. The legislative history of the 1933 Act reflects a Congressional objective to protect investors from fraudulent practices in the sale of securities.

"[C]ourts will construe the details of an act in conformity with its dominating general purpose." *SEC v. C. M. Joiner Leasing Corp.,* 320 U.S. 344, 350 (1943). The "dominating general purpose" of the 1933 Act, as the court of appeals noted, was the protection of purchasers of securities. [Pet.App. 6a-8a.]

[34]The contrary language in *United States v. Brown,* 555 F.2d 336, 338-9 (2d Cir. 1977), cited by the Government [G.Br. 22], should be viewed in light of the court's conclusion that an investor was in fact defrauded, and that the particular scheme there involved constituted a "massive assault on innocent investors".

Both the 1933 Act and the Securities Act of 1934 followed the market crash of 1929, and an intensive investigation by the Senate Banking and Currency Committee.[35] The 1933 Act was preoccupied with the regulation of public offerings of securities. The 1934 Act was directed to abuses in the trading of securities in the "aftermarket".

The 1933 Act represented "but one step", and was enacted for the purpose of "protecting investors and depositors." It was to be "followed by legislation relating to better supervision of the purchase and sale of all property dealt in on exchanges. . . ." President's Message to Congress (March 29, 1933).[36] The Act was drafted so as "not [to] affect transactions beyond the need of public protection in order to prevent recurrences of demonstrated abuses." H.R. Rep. No. 85, 73d Cong., 1st Sess. 9 (1933).

[35]Landis, *The Legislative History of the Securities Act of 1933,* 28 Geo. Wash. L. Rev. 29, 30 (1959).

[36]*See also* 77 Cong.Rec. 2948 (1933) (remarks of Rep. Mott); 77 Cong. Rec. 2915 (1944) (remarks of Rep. Sabath). In fact, criticism was leveled against the 1933 legislation for its failure to regulate trading abuses:

> I am in hearty accord with this measure. It will be a forward stride and will protect the American public and the buyers of securities. However, it will not reach evils from which the American people have suffered in recent years and from which they are still suffering.
>
> The manipulation of securities after they have been issued embraces and constitutes a greater evil than those arising from the original issue of securities. I refer to the vicious and criminal practices indulged in by stockbrokers but which are possible under the rules and regulations of the New York Stock Exchange. These should be dealt with by Congress.
>
> One of the worst evils is that of short selling.

77 Cong. Rec. 2941 (1933) (remarks of Rep. Smith).

> I had hoped that we would enact a bill at this time that would forever prevent dishonest listings and transactions. But unfortunatelv the committee came to the conclusion that at this time they could not do it all in one bill. . . .
>
> But I renew the notice that I served on the House three and a half years ago that I will not desist until these invidious and thoroughly reprehensible practices of short selling, "selling against the box" and floor trading are abolished.

77 Cong. Rec. 2915 (1933) (remarks of Rep. Sabath).

The "demonstrated abuses", in turn, overwhelmingly related to the need for adequate and accurate public disclosure in the initial public offering of securities.

The 1933 Act, in short, was designed to protect purchasers of securities. Every debate, every report and every hearing with respect to the Act is so permeated by that fundamental legislative aim that the recitation of each supporting reference would serve no real purpose.[37]

The method chosen for implementing the objective was to compel the disclosure of all material information to securities purchasers, through a general registration requirement for public offerings, rather than attempting to prohibit the distribution of worthless securities. In essence, Congress preferred to "protect . . . the public by informing the investor". House Hearings at 10 (remarks of Huston Thompson, drafter of the original House bill). "[T]he truth must be told to the purchaser." *Id.* at 58 (remarks of Mr. Pettengill).

To bolster the objective, Congress sought to impose civil and criminal liability on those who failed to meet the required standards of disclosure.

The civil and criminal liability sections were intended as adjuncts to the general policy of disclosure, as is evident from their language. Sections 11 and 12, the civil liability sections, expressly limit relief to purchasers.[38] Section 17, the criminal liability section, was viewed by Congress as the criminal counterpart of the civil liability sections.[39] "Under the bill in case of fraud or misrepresentation in the sale of securities, the remedies are as follows: (1) The purchaser may rescind the transaction and sue for a return of his money . . . (4) Those guilty of the fraud may be prosecuted criminally. . . ." S Rep. No. 47, 73d Cong., 1st Sess. (1933)[40]

The legislative history of the 1933 Act does contain isolated and oblique references to the protection of "honest business", as the Government says. [G.Br. 19-20.] The overwhelming conscious purpose of the Act, however, was

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[37] *E.g.*, "The operation of the bill looks rather to the interest of the purchaser." Hearing on H.R. 4314. Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. (1933) (hereinafter, the "House Hearings") at 44. "We have got to keep in mind all the time the people who purchase the stocks and securities and who have lost everything." House Hearings at 124. "We will prevent damage to purchasers." House Hearings at 212. "[T]he purpose of the bill under consideration is to protect the investing public . . . ." 77 Cong. Rec. 2930 (1933) (remarks of Rep. Wolverton). "It is a bill intended for the protection of the American public from the purchase of worthless and fraudulent securities." 77 Cong. Rec. 2934 (1933) (remarks of Rep. Chapman).

[38] Section 11, 15 U.S.C. § 77k, creates civil liability to purchasers for misleading registration statements. It provides in part: "In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omited to state a material fact required to be stated therein or necessary to make statements therein not misleading, *any person acquiring such security* . . . may, either at law or in equity, in any court of competent jurisdiction, sue . . . [underwriters and others named in, or contributing to, registration statements]." [Emphasis added]. Section 12 is quoted in n. 32, *supra*.

[39] Section 17 was derived in substantial part from New York's "Martin Act". Herlands, *Criminal Law Aspects of the Securities Act of 1933*, 67 U.S. L. Rev. 562, 571 (1933). Liability under the Martin Act arises only for fraud on a purchaser. *People v. Wachtell*, 181 Misc. 1010, 47 N.Y.S.2d 945, 946 (1943); *People v. F. H. Smith Co.*, 230 App. Div. 268, 243 N.Y.S. 446, 449 (1930).

[40] The major distinction perceived between the civil and criminal liability sections related to the fact that imposition of criminal liability would sometimes require greater culpability. "This bill makes absolutely responsible the issuer, the underwriter, and the dealer. It makes him responsible civilly if he sells stocks upon misrepresentation; it makes him guilty of fraud and criminally liable if he sells it with misrepresentation and *fraudulent intent*." 77 Cong. Rec. 2919 (1933) (remarks of Rep. Rayburn). [Emphasis added.] "They are not only liable civilly for an untrue statement of a material fact and for the omission to state a material fact, but they are also criminally liable when they fail to do that which was required of them and which was done with the purpose to defraud the *purchaser of the security*." 77 Cong. Rec. 2924 (1933) (remarks o. Rep. Bulwinkle). [Emphasis added.]

the protection of securities purchasers. The Act was designed to proscribe conduct by broker-dealers, as underwriters, and not, as the Government suggests, to protect them from deceptive practices by their customers.[41]

In summary, the 1933 Act was conceived by Congress to compel disclosure of material information in public securities offerings, in order to protect purchasers of securities. Section 17(a)(1) should be construed and limited accordingly in this case.

4. Securities trading in general, and fraudulent short-selling and illegal extensions of credit on securities in particular, are governed by the Securities Exchange Act of 1934.

The 1934 Act represented the "second step" in the federal regulation of securities, regulation of the trading of outstanding securities.[42] *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723, 728, 752 (1975). In his message to Congress, President Roosevelt stated that notwithstanding the "first step" embodied in the 1933 Act, "there re-

[41]"The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers in securities of those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise." H. R. Rep. No. 85, 73d Cong., 1st Sess. 4 (1933). "The average investor has little, if any, technical knowledge concerning the value of securities. He relies largely upon the reputation of the management of the corporation, upon the representations of the issuer, the underwriter, and the technical advisers of the corporation. The inevitable result is that unscrupulous issuers and underwriters, acting under the protective wing of interstate commerce, have preyed ruthlessly upon the uninformed and the credulous." 77 Cong. Rec. 2935 (1933) (remarks of Rep. Chapman).

[42]"Mr. Chairman, I am sure that everyone sees the very close intimate relationship between the Securities Act and this stock-exchange bill. The Securities Act deals primarily with original distribution of securities, while the stock exchange act deals with trading and outstanding securities." 78 Cong. Rec. 8107 (1934) (remarks of Rep. Cox).

mains the fact . . . that outside the field of legitimate investment naked speculation has been far too alluring and far too easy for those who could and for those who could not afford to gamble." President's Message to Congress (February 9, 1934).

Two significant concerns during the congressional deliberations were abuses arising from short sales[43] and from extensions of credit by brokers to customers,[44] neither of which subjects had been dealt with in the 1933 legislation.

Thereafter, as adopted, the 1934 Act provided for the regulation of short-selling and other extensions of credit on securities by the Federal Reserve Board [Section 7], with the regulation of the mechanics of short-selling on national securities exchanges left to the SEC [Section 10 (a)]. To complement these measures, Congress enacted Section 10(b) as a "catch-all clause to prevent manipulative devices." Hearings on H. R. 7852 and H. R. 8720, Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934). *See also Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 202, 203 (1976).

[43]Hearings on H. R. 7852 and H. R. 8720, Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 25, 34-40, 44, 46-50, 55, 71, 86, 115, 135, 193-6, 208, 258, 294-5, 305, 337, 441-2, 502-4, 559, 633, 749, 780-2, 826-31 (1934).

[44]One purpose of the 1934 Act was "to discourge use of credit and financing in excessive speculation in securities." Hearings on H. R. 7852 and H. R. 8720, Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934). "The first idea is control of the amount of credit that gets into the market." *Id.* at 85. "This bill is founded upon the theory that in some way an injury is inflicted on our business and financial life by the too easy flow of credit into the stock market." 78 Cong. Rec. 8387 (1934) (remarks of Senator Buckley). "The supplying of credit by a broker to a customer for the purpose of carrying speculative or investment securities creates a relationship which is fundamentally wrong . . ." 78 Cong. Rec. 8386 (1934) (remarks of Senator Buckley).

It is those provisions which directly bear upon the Respondent's short-selling activities, not Section 17(a) of the 1933 Act.

Section 7(c) of the 1934 Act, 15 U.S.C. § 78g(c), provides:

> It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenace of credit to or for any customer—
>
> (1) On any security . . . in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe. . . .

Regulation T, 12 C.F.R. § 220, was promulgated by the Federal Reserve Board in accordance with the statute.

At the time of the occurrence of the events in this case, the onus of compliance with Section 7(c) and Regulation T rested solely with brokers who extended credit, and not customers who received it.[45]

Shortly thereafter, in 1970, Section 7(f), 15 U.S.C. § 78 g(f), was added to the 1934 Act. It provides in part:

> It is unlawful for any . . . person . . . to obtain, receive or enjoy . . . extension of credit from any lender . . . for the purpose of . . . purchasing or carrying . . . securities . . . if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited. . . .

[45] *Pearlstein v. Scudder & German*, 429 F.2d 1136, 1141 (2d Cir. 1970), *cert. denied*, 401 U.S. 1013 (1971) ("[T]he federally imposed margin requirements forbid a broker to extend undue credit but do not forbid customers from accepting such credit"); *Naftalin & Co., Inc. v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 469 F.2d 1166 (8th Cir. 1972); *Moscarelli v. Stamm*, 288 F.Supp. 453, 458 (E.D. N.Y. 1968) ("No duties or restrictions were imposed by the Act and the regulation upon the investor-customer.").

Regulation X, 12 C.F.R. § 224.2, was promulgated by the Federal Reserve Board pursuant to Section 7(f). It provides in part:

> A borrower shall not obtain any purpose credit . . . unless he does so in compliance with the following conditions:
>
> * * *
>
> (2) credit obtained from a broker/dealer shall conform to the provisions of [Regulation T]. . . .

Section 7(f) and Regulations T and X were not available to the Government in the prosecution of the Respondent's 1969 short-selling activities.

As of the present time, however, both brokers and their customers are expressly prohibited from making unmargined short sales by Section 7 and Regulations T and X, under criminal penalty for willful violations. 15 U.S.C. § 78ff.

Section 10 of the 1934 Act *was* available to the Government in the prosecution of the Respondent. Both of its substantive provisions were clearly and unambiguously applicable to short-selling schemes, without the necessity of proving any impact on investors. *United States v. Peltz*, 433 F.2d 48 (2d Cir. 1970).[46]

Section 10(a) of the 1934 Act, 15 U.S.C. § 78j(a), provides:

> It shall be unlawful for *any person*, directly or indirectly, by the use of any means or instrumentality

[46] *Cf., A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 396-7 (2d Cir. 1967).

of interstate commerce or of the mails, or of any facility of any national securities exchange—

> (a) *to effect a short sale* . . . of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe *as necessary or appropriate in the public interest* or for the protection of investors. [Emphasis added.]

As it existed in 1969, Rule 10a-1, 17 C.F.R. § 240.-10a-1, promulgated by the SEC under Section 10(a), read as follows:

> No person shall for his own account or for the account of any other person, effect on a national securities exchange a short sale of any security (1) below the price at which the last sale thereof, regular way, was effected on such exchange, or (2) at such price unless such price is above the next preceding different price at which a sale of such security, regular way, was effected on such exchange.[47]

Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * *
>
> (b) *To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange* or any security not so registered, *any manipulative or deceptive device or*

[47]Rule 10a-1 is known alternatively in the securities industry as the "up tick" or "down tick" rule. It is designed, as the Government notes [G.Br. 26], to prohibit short-selling in a declining market.

> *contrivance* in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate *in the public interest* or for the protection of investors. [Emphasis added.]

Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated by the SEC under Section 10(b), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) To employ any device, scheme or artifice to defraud,
>
> (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

5. The unavailability of Section 17(a) as an enforcement tool against undisclosed short-selling does not threaten brokers, given the protection afforded by Sections 7 and 10 of the 1934 Act.

The composite of the statutes and rules quoted above is of dual significance here.

First, they provide a complete response to the Government's argument that the "protection of financial inter-

mediaries" requires a broad construction of Section 17(a) of the 1933 Act. [G.Br. 23-7.] All such persons, including brokers, are now fully protected against short selling schemes of the "species" employed by the Respondent under Sections 7(c), 10(a) and 10(b) of the 1934 Act, Regulations T and X of the Federal Reserve Board, and SEC Rules 10a and 10b-5, respectively.

Second, the Government was fully conversant with Sections 10(a) and (b) and the regulations when this prosecution was commenced, and it was fully aware that both provisions had been employed successfully in the past to prosecute short-selling violations by customers. The SEC has alleged violations of Section 10(b) by the Respondent in the same transactions ultimately charged in the indictment, as the basis for both the injunction action commenced in November 1969 and the administrative proceeding commenced in September 1971.

At the same time, the Government knew, as the court of appeals said, that in the entire history of Section 17 (a) of the 1933 Act there existed "no case in which [the statute] has been used to prosecute a defendant for fraud in the sale of securities perpetrated upon an agent-broker, where no investor has been deceived or defrauded as a result of the fraud." [Pet.App. 9a.] The Government's "need" for Section 17(a) as an enforcement tool for undisclosed short-selling, and its conscious decision to pursue Section 17(a) in this case, should be assessed accordingly.

Paraphrasing *International Brotherhood of Teamsters v. Daniel*, 99 S.Ct. 790, 802 (1979), "not only is the extension of [Section 17(a)] by the [Government] unsupported by the language and history of the [1933 Act], but in light of [the 1934 Act] it serves no general purpose."

6. Any ambiguity in Section 17(a) should be resolved in favor of lenity.

Under the circumstances, the Government should not be heard to urge the liberal construction of a criminal statute.

As this Court said in *Foremost-McKesson, Inc. v. Provident Securities Co.*, 423 U.S. 232, 244 (1976), the Government's approach is "unsatisfactory in its focus on situations that [the statute] may not reach rather than on the language and purpose of the . . . provision itself." Even in a civil context, this Court has not been inclined to read a securities provision "more broadly than its language and the statutory scheme reasonably permit." *SEC v. Sloan*, 98 S.Ct. 1702, 1711 (1978). In a criminal context, the statute must be strictly construed, and the Respondent may not "be subjected to a penalty unless the words of the statute plainly impose it." *United States v. Campos-Serrano*, 404 U.S. 293, 297 (1971).

In short, "ambiguity concerning the ambit of a criminal statute should be resolved in favor of lenity." *Rewis v. United States*, 401 U.S. 808, 812 (1971).

CONCLUSION

The writ of certiorari issued to the court of appeals should be dismissed as having been improvidently granted. In the alternative, the judgment of the court of appeals should be affirmed.

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